COMMERCIAL CREDIT OR DISCOUNT COMPANIES

There have been developed in recent years a number of financial institutions whose work, like that of the commercial paper houses, is mainly that of intermediary between borrowing businesses and lending banks. The institutions in question are variously designated as discount houses, finance companies, commercial credit companies, commercial acceptance trusts, automobile banks, etc. It is somewhat difficult to describe the work of these companies, for the reason that the terminology commonly employed in describing their operations is far from uniform—and the principles of operation themselves not highly standardized. Moreover, since certain houses specialize in a particular type of operation, while others engage in more than one form of financial enterprise, it is impossible to state that the financial institutions in question are always conducted on principles thus and so. There are, however, at least two distinct types of financial enterprise which may be differentiated: (1) the purchase of accounts receivable from business concerns—in various lines—which are in need of additional working capital; and (2) the financing of the distribution of automobiles and other products that are commonly sold on the instalment plan.

I. PURCHASING ACCOUNTS RECEIVABLE

There are two principal reasons why business concerns on occasion sell or assign accounts receivable: (1) to secure the necessary funds with which to postpone or forestall financial insolvency; and (2) to secure additional working capital with which to expand the volume of business. The first practice is usually regarded as "illegitimate" financing, something to be frowned upon by all conservative and constructive business men. The second—a development of the last ten years—is, as we shall see, in a very different category. Let us consider each in turn.

1. *Assigning of accounts by concerns that are financially involved.* Suppose a certain business, which has $10,000 of accounts receivable, is in financial straits and must have immediately, say, $5,000 in cash. Unable to borrow on its own note, and having neither customers' notes nor trade acceptances available for discount at a commercial bank, it still has in its accounts receivable a resource which can be converted into cash through the intermediation of a discount house. By purchasing these accounts at a substantial discount and collecting them in full at maturity, a discount company can at once provide the necessary financial assistance to the enterprise in question and earn a profit for itself. The discount company receives the funds which it advances partly from its shareholders, but more largely from the commercial bank from which it borrows on its promissory note, secured by the purchased accounts as collateral. The amount of the discount varies somewhat, but in the nature of the case the rates are very high, usually ruinously so.

Concerns which sell accounts receivable are commonly viewed with suspicion by the commercial bankers. It is argued that the high-interest rates at which such loans are secured are prohibitive, and that the credit standing of the concern is thereby seriously impaired, with the result that eventual bankruptcy is rendered the more certain. While this is undeniable, generally speaking, there are doubtless numerous cases where enterprises, temporarily embarrassed, have thus been tided over a difficult period in their history.

2. *The sale of accounts by "well-rated" concerns as a means of increasing working capital.* There has been developed in the last few years a new type of discount or commercial credit company—one whose function is to furnish funds, not to concerns that are financially involved, but to well-rated enterprises, which are in a position to make an effective use of more money than they can secure through regular banking channels.

In periods of very active business, particularly, many concerns find that after they have utilized the full lines of credit extended them by the commercial banks they could make a profitable use of more funds. Indeed, even before the maximium line of credit

at the bank has been utilized, a concern often resorts to the sale of receivables in order to keep some of its bank credit available for an emergency. The money borrowed may be devoted to expanding the volume of business through the purchase of additional raw materials or merchandise, or it may be used to pay off trade bills, thereby saving the discount that is offered for early cash payments. While the rates charged for such funds are high, the cost is usually less than the amount of the cash discount on trade bills which can thus be saved.

The character of the business concerns which make use of such credit sources may be seen from the fact that one discount house in 1918 made 77½ per cent of its $55,000,000 of loans to customers whose commercial ratings were of the first or second classes. Nearly 75 per cent of the customers, moreover, were concerns rated above $35,000, some of them at more than $1,000,000, the average size being between $50,000 and $75,000. It should be clearly understood, however, that while the concerns which borrow in this way may typically be well rated and of fair size, the resort to the sale of accounts receivable as a means of raising funds indicates a credit condition temporarily such that commercial banks are unwilling to lend them more.[1] Concretely, the concern's ratio of quick assets to current liabilities is as a rule considerably less than what is customarily insisted upon by the commercial bankers.

The high-grade credit companies engaged in such financing operations sometimes discount the accounts receivable, but more commonly they make a "service charge" instead. For instance, one large commercial credit company advances about 80 per cent of the face value of each account at the time of purchase, and the balance as it is collected. It derives its profit by a gross charge of one twenty-fifth of 1 per cent on the net face of accounts for each day, or a little over 1 per cent a month, plus $5 per $1,000 on the first $100,000 worth of purchases from any concern in any one year. In order that the customers of a concern may not be disturbed, an arrangement is made whereby the borrower may do his own

[1] Except of course in cases where the bank credit line is being held open, as noted above.

collecting; thus the customers need not know that their accounts have been sold. This is known as the "non-notification" plan.

This company makes a careful credit investigation both of the customers who owe the accounts receivable and of the seller of the accounts. It makes use of Dun's and Bradstreet's commercial ratings, and will not buy from any one concern the accounts of customers having a poor credit rating to an amount in excess of 20 per cent of the total volume of accounts purchased. As a further means of minimizing risks it also seeks to have its accounts from each borrower as widely distributed as possible.

The company makes a careful investigation of the credit standing of the seller of accounts, including an analysis of his financial statement, for the reason that in the last analysis the seller of the accounts is looked to for payment. Indeed, the seller is required to warrant the accounts, thus assuming a secondary or contingent liability. Inquiry is also made as to the use to which the borrowed funds are to be put; and the loan is ordinarily refused if the money is to be devoted to an increase in fixed rather than working capital. The discount company is thus reasonably well protected from loss. It may be added that the methods just described are typical of the largest institutions.

Discount companies borrow heavily from commercial banks. The capital and surplus of these concerns serve largely as a basis for credit with the banks from which they borrow heavily, usually on their promissory notes secured by collateral. One conservative company with a capital stock of $1,320,000 in 1920 had a maximum loan account at the banks of $4,302,000, with an additional $402,000 borrowed through a commercial paper house. It is not uncommon, however, to find the amount of borrowed funds from five to ten times the amount of the company's capital. In seeking a loan the company always presents a financial statement showing its resources and liabilities. The average cash balance on hand, plus the average monthly collections, usually exceeds the total of all notes payable. It is necessary for these companies to maintain a high credit standing with the banks, for they are almost continuously dependent upon them for funds.

The selling of accounts receivable by a business concern in need of funds with which to expand its business is usually justified economically on the ground that it is the most convenient as well as the cheapest means of securing the additional capital required. It is more convenient than a resort to the sale of additional stock, and at the same time it does not permanently increase the capital. Because of the necessity of formulating business policy with a view to long-run conditions—for periods of depression as well as for times of great business activity—this ability to expand capital resources by short-time borrowing rather than by permanent capital contributions is a matter of genuine importance.

Does credit extension by credit companies result in dangerous business expansion? One question of general moment may be raised here, however. Is the expansion of business that is thus made possible economically desirable? Would it not be better if the verdict of the commercial bankers were allowed to stand—the verdict that the concerns in question have already borrowed as much as their financial status warrants? Does such credit extension not lead to undue or dangerous expansion? It should be observed in this connection that while the commercial banks would not directly extend so large a volume of credit to borrowers as they secure through the aid of these financing corporations, the funds secured are nevertheless largely drawn from the commercial banks by an indirect process. Where it would be regarded as unsafe to make additional direct loans to the borrowers in question, the interposition of a strong financial intermediary renders the indirect extension of such credit eminently conservative. But safety to the loaning banks, immediately speaking, is one matter and safety to the general business and credit structure in the longer run, is another. It may reasonably be contended that during periods of great business activity and attending financial strain the added expansion of credit which these institutions make possible only serves to make the task of eventual credit contraction and business readjustment the more difficult.

It should be observed in this connection that the discount of trade acceptances in order to expand a concern's working capital

is open to precisely the same objection. It is because of this that conservative bankers refuse to increase a borrower's "line of credit" merely because he discounts acceptances.

From another point of view, however, such credit extension presents itself in a much more favorable light. If the funds borrowed are used to save the cash discount offered by mercantile creditors, rather than to attempt an expansion of the total volume of business through the purchase of additional raw materials or stocks, the result is undoubtedly beneficial from the point of view of the general credit situation.

Finally, it may be observed that these institutions have thus far had little experience with the financial problems incident to a long period of business depression. An outgrowth, in the main, of the financial conditions of the war period since 1914,[1] these companies to date have had nothing but fair weather. Business failures have been almost negligible and the opportunities for making profits quite unprecedented. In consequence, the risks assumed by these houses have been very small and their profits almost unbelievably large. During a period of depression, however, they will doubtless find that they must greatly reduce the volume of their loans; for in periods of declining business, credit lines at the local banks are ample for all concerns that are in a sound financial condition. As a means of forestalling financial disaster, however, weakened enterprises at such a time will, of course, seek credit accommodation from these companies with renewed vigor. It is a safe guess, however, that such concerns will find little encouragement from the high-grade conservative credit companies which we are here considering.

II. THE FINANCING OF AUTOMOBILE DISTRIBUTION

The extensive growth of the automobile industry during the last twenty years has given rise to a very interesting system of financing the distribution of the product. The institutions engaged in this financing are variously known as commercial credit companies, discount houses, and automobile banks. Some of them

[1] Very few companies were in existence before 1914 and none, apparently, for more than two or three years.

are specialists in this field and others are not. For instance, the commercial credit company described above devotes a large percentage of its resources to the purchase of automobile paper. It should also be kept in mind that some houses also deal in piano furniture, and other paper, growing out of the sale of goods on the instalment plan. For convenience of expression, we shall, however, here designate the institutions in question as automobile banks.

The reasons for the development of the automobile bank are inherent in the nature of the distribution end of the automobile business. The automobile, despite the current assertions that it is a necessity, has always been looked upon by the commercial bankers as in a different class from staple products—as involving relatively large risks. Automobile dealers, as distinguished from the manufacturers, commonly have relatively small resources; they buy cars largely on credit and in turn sell them largely on credit. It has been estimated, indeed, that 65 per cent of the passenger cars and 90 per cent of the trucks are sold on time. Since the automobile is ordinarily in the nature of a luxury, it quickly becomes a drug on the market in a period of business depression, and since second-hand cars are subject to very heavy depreciation, commercial banks have not been willing to extend credit to automobile dealers in proportion to their requirements in periods of rapid expansion. Hence the necessity of and the opportunity for the automobile banker.

The work of the automobile bank is similar to that of commercial paper houses and discount companies. It is something more than a broker in that it advances the funds to borrowers, and it is something less than a bank in that as a rule it promptly shifts to the regular banks the burden of carrying the loan. While similar to the institutions already described, it has nevertheless evolved certain distinct financial methods.

There are two types of automobile financing operations to be described. First, certain large credit companies extend what may be called wholesale credit to automobile dealers; second, there are many smaller financing corporations which specialize in the making of retail loans secured by the instalment notes of the ultimate purchasers of the cars. While some companies engage in both

types of operations, as well as in the purchase of accounts receivable from other businesses, as described in the section above, it will make for clearness if we describe the different operations as though the institutions engaging in them were specialists.

1. *The wholesale plan.* The financing conducted under the first plan is designed to enable the dealer to secure the funds with which to pay the manufacturer for the cars without waiting for their sale to, or at least without waiting for final payments from, customers. In a sense they are therefore financing the manufacturers themselves. The loans are made to the automobile dealer, who gives his promissory note to the automobile bank, together with chattel mortgages on the cars in his possession. It should be stated, however, that it is only in certain states that we find the chattel mortgage. In some states a trust receipt is used, and in still others a conditional sale agreement is employed, the particular type being determined by the varying laws of different states.

When cars are stored "on the floor" the chattel mortgage or other document covers a particular car, which can be disposed of only on terms laid down in the agreement with the automobile bank. There have been many cases of fraud and deception, however, in connection with this floor plan, chattel mortgages often being given on cars which do not exist, or which are not owned by the dealer in question; and there are many cases of secret sale of the car against which the mortgage stands. Where cars are stored in a warehouse, however, the warehouse receipt is turned over to the automobile bank. In such a case the bank is much more adequately protected; and, it may be added, the loan is usually more nearly equal to the full value of the car.

Since the dealer is constantly selling cars, it will be seen that the security commonly passes out of his possession during the life of the loan. But under the terms of the agreement with the dealer, the claim against the car still rests with the automobile bank. It should be observed, however, that the bank does not look to the individual who has purchased the car on the instalment plan for a payment; he still looks to the dealer, to whom he has made the loan and whose note he holds.

It will be seen from the foregoing that the credit standing of the dealer to whom the loan is made is of paramount importance. Accordingly, the automobile bank makes a careful investigation of the dealer's moral and financial standing, even requiring him, as a rule, to furnish a statement showing his financial condition. While each particular loan is in fact secured by a chattel mortgage on a particular car, the main reliance is nevertheless placed upon the dealer's general responsibility. Loans made to dealers in this way commonly run for two or three months. While the loans are made to the dealer, it should be added, however, that where cars are held in storage, it is customary for the manufacturer to guarantee the payment of the loan. Thus the automobile bank often has two-name paper.[1]

Such companies derive their profits from a gross "service charge" similar to that described above in connection with the purchase of accounts receivable. This charge covers interest and profits and also insurance against theft and fire. The company will not make a loan on an uninsured car; and by acting as agent for an insurance company, it obtains a large commission on all insurance that is written. The "service charge" varies somewhat, but is always high enough to insure a very handsome return to the company.

2. *The retail plan.* A concrete illustration of the practice followed by a particular discount company will indicate the difference between this method of financing and that which we have just described. Let us assume that a dealer has sold a car valued at $6,000 and has received $1,000 down and for the remainder instalment notes of $500 each, payable monthly.[2] A chattel mortgage is also given by the purchaser. The dealer borrows $4,000 from the automobile banker, putting up the $5,000 in instalment notes as collateral security. The dealer usually guarantees the payment of such notes. The bank loan is typically, as in this case, 80 per cent of the value of the notes offered as collateral

[1] The manufacturers, however, practically never guarantee the payment of *retail* loans. There is apparently but a single exception to this rule.

[2] The average duration of such credit extension is about eight months.

security. Since the purchaser's notes are paid in monthly instalments, the dealer is required to pay his loan to the automobile bank in monthly instalments.

It is the common practice with these smaller companies to *discount* the dealer's notes, usually at 5 per cent. And since the notes usually bear interest at 7 or 8 per cent, the company always secures 5 per cent on the face of the note plus, say, 7 per cent interest on that portion of the loan which it finances out of its own resources. Moreover, since the company can usually borrow from the commercial bank on its own note, secured by the instalment notes received from dealers as collateral, at a rate lower than that which the notes themselves bear, it will be seen that some additional profit is thus procured. It will be apparent, however, that it is the 5 per cent discount that constitutes the main source of income.

The extent of the gross profits that may be obtained therefore depends largely upon the volume of loans that can be made. Since the dealer is required to pay his loan to the automobile bank in monthly instalments, this bank is in fact in a position at the end of each month to make a new loan of several thousand dollars on the basis of the instalment receipts, borrowing as before 80 per cent of the amount from a commercial bank, on the collateral security of a new dealer's note and chattel mortgage. These monthly payments, it will be observed, will prove cumulative as additional loans are extended, each of which calls for monthly payments. In fact, by virtue of its ability to borrow from the commercial banks, a company is in a position rapidly to pyramid the volume of its business. It is commonly believed that loans may safely be made to eight or ten times the amount of the company's capital.

The profits of such companies have, in fact, often been very large, though the earnings fluctuate widely, varying with changing conditions in the automobile industry. It may be noted that the clerical force required to run such an institution is very small. There is usually only a manager, an assistant manager, a bookkeeper, and a stenographer, with one or more salesmen.

These companies have also, to some extent, financed auto trucks and tractors. But the hazards here have been found considerably greater than in the case of passenger cars. This is particularly

true of tractors, which are subject to a rapid depreciation because of the farmer's customary failure to house them properly against inclement weather. Trucks are also subject to heavy depreciation; and it appears that the moral hazard, also, has proved greater with trucks than with passenger cars.

The funds employed by automobile banks are procured in a variety of ways. Thus far we have been placing emphasis upon the methods by which the automobile bankers—both wholesale and retail—extend credit to the automobile industry, only incidental reference having been made to the sources of the funds used by these institutions. In fact there are several different methods by which the automobile bankers secure the funds which they lend. In all cases, of course, a part of it is derived from the capital contribution of the company's shareholders; but this capital is mainly employed to serve as the basis of the company's own credit. These institutions secure the funds which they loan, in four different ways, some companies using but a single method, others at one time employing one means and again another, and some of them now and then using a combination of methods simultaneously.

First, they may borrow from the commercial banks, or through commercial paper houses, on their single-name promissory notes, without other security. So far as the author is aware, there is only one company using this method. Second, they may borrow from commercial banks on their promissory notes, secured by the instalment notes of the purchasers of cars. The officers of the credit company also frequently indorse the notes. Third, they may raise the funds by selling the company's unsecured debenture bonds in the investment market. This method is apparently not very commonly employed. Finally, they may secure the money by selling in the investment market collateral trust notes or bonds.

The last method, only, requires explanation. The company assigns the notes received from its customers, together with the chattel mortgages or other documents, to a trust company where they are held in trust as collateral for the bonds to be issued. Guaranties from the various dealers who have given notes to the effect that both principal and interest will be promptly paid are also turned over to the trust company. The financing corporation

then issues its own obligations, secured by these commercial notes, mortgages, and guaranties, and offers them for sale in the general investment market. They are usually issued as short-term serial notes, some of which mature every few months.

The following statement of a "commercial security" company which purchases mortgages and leases on cars and pianos will serve to show the exact nature of the security possessed by the purchasers of the company's bonds.

First: Financial statement of dealer on form supplied.

Second: Execution of an agreement in duplicate on forms furnished, covering details and conditions of purchase of mortgages and leases.

Third: Naming of someone in vendor's employ to be authorized to make collection on mortgages and leases purchased, who shall be bonded by fidelity bond to make prompt remittance of collections, as provided in agreement.

Fourth: Listing of mortgages and leases offered for sale on blanks furnished, duly assigning and guaranteeing mortgages and leases listed.

Fifth: Mortgages and leases must show that they have been recorded, if required by state law, and recorder's certificate of filing must be attached.

Sixth: Mortgages and leases must show a minimum cash payment of 20 per cent of purchase price.

Seventh: Mortgages and leases must draw at least 6 per cent interest per annum.

Eighth: Final instalments on mortgages and leases must mature within thirty-one months of date of sale to the Company.

Ninth: Under the terms and agreements to be entered into, mortgages and leases are to be purchased for 90 per cent of the balance due and owing thereon, payable 70 per cent at the time of purchase, and the balance in quarter-annual payments of 20 per cent of amounts collected and remitted on mortgages and leases, provided that no payments on same are in default, in which case same will be held until such defaults are settled.

Tenth: Mortgages and leases must be guaranteed both as to principal and interest by the dealer or manufacturer from whom they are purchased.

The leases referred to relate to the loan of a piano or car to the purchaser during the period when it is being paid for.

These credit companies render important economic services. The nature of the service rendered by these financing corporations in

connection with the automobile and similar industries was suggested in the introductory paragraph of this section, on p. 833 above. The process of marketing automobiles, pianos, etc., is such that the regular financial institutions have neglected the financial requirements of these industries, particularly in periods of rapid expansion. Credit companies have therefore filled a breach in the financial structure and devised methods which at once minimize their own risks and insure the earning of large profits, while at the same time they make it possible for the commercial banking institutions and the investing public indirectly to furnish the funds required. Without them it is believed that the development of such industries would have been very seriously impeded.

In the city of Chicago alone there are more than thirty financing corporations of the types which we have been considering, while in New York there is an even greater number. They are, moreover, found in nearly all parts of the country—wherever the need for them has been manifested. An interesting development in the last year or so has been the organization of auto-finance credit associations in New York and Chicago. The purpose of these associations is to exchange information with reference to the credit standing of borrowers; and to co-operate in every way in raising the general plane of the business. Like the commercial paper houses, the discount companies are subject to no special legal regulations, being governed only by the general laws relating to ordinary corporate and business activities. While their operations have, as a rule, not yet been placed upon so efficient a basis as those of the commercial paper houses, they are being rapidly improved, and will no doubt eventually assume a highly standardized form. In any event these institutions have already achieved a permanent place in the American financial system.

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